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Tax Court Decision Addresses Tax Deductibility of Payments under Management Services Agreement

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Recent Case Emphasizes the Need for Careful Planning When Structuring Agreements

In a recent Tax Court decision, a dental group was denied a deduction for payments made under a management services agreement with a separate company owned by an employee stock ownership plan that benefited employees of the dental group. Although the facts in the case are unique (in that both the dental practice and the management company were controlled by the "same" person), care should be taken in structuring arrangements between professional practice groups and companies that provide them with management services.

In *Wiley M. Elick v. Comm'r*, TC Memo 2013-139 (June 3, 2013), the Tax Court upheld the denial by the Internal Revenue Service of deductions for payments made by Dr. Elick's dental practice professional corporation of $430,000 and $303,000 for the two tax years in question to a management company that was owned by an employee stock ownership plan of which the practice group's employees were beneficiaries. In reaching its decision, the Court cited several factors.

First, prior to entering into the management services agreement, the dental practice had employed a bookkeeper to handle billing, collection, and accounting services. Even after the agreement was entered into, the professional corporation continued to employ the same person as a bookkeeper. Although Dr. Elick became a co-employee of the management company and the management services agreement required the management company to provide budget planning, fiscal services, and regulatory compliance activities, the management company had no paid employees, and it was unclear to the Tax Court that any activities were actually performed by the management company for the practice PC.

Moreover, the dentist did not receive compensation from the management company. In fact, the court found that there was no correlation between the $733,000 paid by the practice entity and the actual services "rendered" by the management company; the only justification for these payments was that the management agreement required the payment of a certain percentage of revenues of the practice for such services. The Tax Court concluded that there was no proof that services were actually performed by the management company in return for these payments.

Several lessons can be learned in structuring arrangements by which separate companies provide management services to professional practice groups, particularly where there is common ownership of the management services company and the practice entity. First, care should be taken to properly document that the management entity actually provides services to the practice group. In this manner, the practice entity can substantiate its benefit from the contractual relationship. In other words, "value for services rendered" can be shown since the practice group received and benefited from the services provided by the management company.

In addition, pricing of management services should be reasonable since, if called into question by the Internal Revenue Service, the Tax Court will view related party arrangements with special scrutiny. "Reasonableness" as to the amount and method for payment of compensation can be evidenced by the practice entity's receipt of proposals from third-party companies to provide similar services. The management agreement should call for compensation at no higher a rate than the amounts proposed by third parties.

In summary, the Tax Court did not invalidate the use of management services agreements by professional practice groups. It indicated, however, that a high degree of care and planning should take place not only in structuring but in the operation of these arrangements.

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